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TAGS: ECON PGOV EAID EFIN KCOR KE
SUBJECT: IMF BRIEFS DONORS ON KENYA'S ECONOMY AND PRGF
PROGRESS

Ref: Nairobi 3129 and previous

Sensitive-but-unclassified. Not for release outside USG
channels.

¶1. (SBU) SUMMARY: IMF Mission Chief for Kenya Godfrey Kalinga briefed donors on the results of a 10-day IMF mission examining Kenya's progress on the second review of its three-year $326.7 million Poverty Reduction and Growth Facility (PRGF). Kalinga was generally optimistic on Kenya's near-term economic performance and on progress made in meeting the second review's performance criteria and benchmarks. He noted that sustained growth rates and progress on meeting the Millennium Development Goals (MDGs) will require improvements in Kenya's infrastructure and better budget management. Kalinga assured the donors that the IMF remains concerned about governance, but is willing to work around the unfinished business of verification of public officer asset declarations in order to have a successful Executive Board Meeting, likely on December 21. We remain worried that Kenya's budget spending will become increasingly politicized in the run-up to the November 21 constitutional referendum and the subsequent presidential election. We also hope Kenya will focus its economic policies towards sound, pro-growth initiatives, and not simply target the MDGs. END SUMMARY.

Economic Developments

¶2. (SBU) IMF Mission Chief for Kenya Godfrey Kalinga briefed donors on October 28 on the results of a 10-day IMF mission on the second review of Kenya's three-year $326.7 million Poverty Reduction and Growth Facility (PRGF). Kalinga said the IMF Executive Board is currently planning to meet on the Kenya program December 21, when it is likely to give a passing grade and authorize disbursement of the next US$ 72.6 million tranche of the credit.

¶3. (SBU) Kalinga confirmed the IMF's previous estimate of at least 5% GDP growth for Kenya in 2005. The economy is performing better than anticipated one year ago, partly because growth is spreading to a broader range of sectors. He was also guardedly complimentary of the GOK's fiscal management for both revenues and expenditures. With revenues exceeding projections, the expected budget deficit will likely not occur. Due largely to favorable weather

conditions leading to lower food prices, inflation has receded during the past few months. At the same time, for Kenya to achieve significant transformational economic performance, it needs growth rates considerably higher than 5%.

¶4. (SBU) The medium term outlook is also brightening, particularly because of improved security in Southern Sudan, resulting in increased economic activity for Kenyan goods and service suppliers. Kalinga cautioned that Kenyan companies and authorities still needed to "take advantage of these opportunities."

¶5. (SBU) When asked, Kalinga admitted that there remains a significant "ceiling" on medium-to-long term growth, most notably from a lack of investment in Kenya's deteriorating infrastructure. Despite recent upturns in manufacturing and trade, even 5% growth might not be possible beyond FY2005/6. At the same time, Kalinga cited some important initiatives that should pay economic dividends, including a World Bank funded (and USAID/REDSO-supported) program to improve the Northern Transit Corridor, the recent joint Kenya-Uganda private contract for managing rail freight, a proposal to accelerate telecom reform, a more flexible approach to water management, and a proposal for privatizing container handling at the Port of Mombasa.

Pushing Good Governance

¶6. (SBU) Kalinga assured the donors that the IMF remains concerned about governance issues, saying, "it is a key issue for all of us." He sees some progress in the GOK's ability to investigate and prosecute corruption cases, but sees a need for additional capacity in these areas to deal with an "expected increase in cases." [Note: USAID/Kenya is providing support to strengthen the performance of the Department of Public Prosecutions. End note.] He also expressed concern for Kenya's underperforming parliament, and explained that without passage of the Miscellaneous Amendments Act, enabling legislation will not be in place for verifying senior GOK officials' asset declarations, which is a prior action for this second review. Since parliament is unlikely to be in session again before the board meeting, Kalinga said that the IMF is working with the GOK on "substituting some other actions that will enable us to meet this requirement." Specifically, the IMF has asked the GOK to develop an enhanced code of conduct for government officers, for both their official activities and private business interests.

¶7. (SBU) Prior to the board meeting, Kalinga hopes to see additional GOK efforts to improve fiscal "soundness," including more progress creating a robust expenditure monitoring system. Looking further out, Kalinga highlighted the need to supplement the legislative framework in the fight against corruption, including, he hopes, passage of anti-money laundering legislation next year, and enhanced parastatal reform to include regular account audits.

An Improving Budget

¶8. (SBU) In response to a question from USAID, Kalinga noted that improved management of expenditures is necessary for both Kenya's recurrent and its development budgets. However, with the recurrent expenditures dropping slightly to 20% of GDP and development funding increasing from 2% to 7% of GDP in recent years, the GOK needs to improve its development processes and absorptive capacity. With development resources coming from donor programs at approximately 4% of GDP, the GOK is hindered by the multiplicity of negotiations and funding conditions by the various donor organizations. Kalinga agreed that even the recurrent budget is bogged down by the huge number of regulations and implementation instruments required by

Kenya's vast bureaucracy. President Kibaki needs to lead the way on more clearly-elaborating policy priorities, allowing the bureaucracy to be more proactive, rather than having "everything decided by the cabinet" which meets infrequently. Kalinga is hopeful that the implementation of the Public Procurement Act, which was recently signed by Kibaki, will improve budget management for both development and recurrent spending. [Note: Another component of this effort is Kenya's Public Financial Management Reform Program, which the GOK hopes will be partially funded through its not-yet approved MCC Threshold program. End Note.]

¶9. (SBU) When asked if he has confidence in the GOK's handling of expenses related to the current constitutional referendum campaign, Kalinga replied that there were clear line-items for additional referendum-related security measures, but that it is not possible to track all the funds. In part, this is because Kenya needs more time to finish implementing its new system for allocating and monitoring expenditures. He admitted not having a complete picture of how the budget is passing through the ministries, but hopes that will become clearer by mid-January. Kalinga opined that he would like to see more effective parliamentary oversight of the budget, but that is "outside the scope" of the IMF mission. [Note: USAID/Kenya's support for Parliament Strengthening provides assistance to budget oversight committees to enhance their capacity in this area. End note.]

How About the MDGs?

¶10. (SBU) Asked if Kenya's budget was on the right track for meeting the Millennium Development Goals (MDGs), Kalinga responded that Kenya needs to target around 4% of GDP to the MDGs to make real progress (and will require higher than 5% GDP growth), but this is not currently possible. He also noted that the GOK needs to continue reducing some budget areas, such as defense spending and

overseas diplomatic missions in order to create "fiscal space," and the ability to quickly address pressing needs, but, the country is still 2-3 years away from making this happen. Also, according to Kalinga, Kenya's expenditure process is too inflexible to effectively address the MDGs. He feels that government decisions on allocations for key areas take much too long.

¶11. (SBU) Kalinga said that Kenya will also require more donor funds. He elaborated that the current problem with absorptive capacity is not a significant concern if the aid is addressing areas that can utilize significant increases, like education and healthcare, and as long as the bureaucracy does not have to deal with too many separate administrative requirements. He estimates that Kenya can manage additional donor contributions up to 7-8% of GDP, especially if some of that is managed by contractors.

¶12. (SBU) Kalinga admitted that the second review's performance criteria for new wage guidelines continues to slip, but that Kenya would be granted a waiver. In what is a slight restatement of this criterion, he added that stabilization of the wage bill is the goal, not substantive cuts, since much of Kenya's development objectives are "labor intensive."

Exchange-Rate Angst

¶13. (SBU) When asked about the current strength of the Kenya Shilling (currently trading at about 73 to the dollar, as opposed to a more historical level of 78/dollar), Kalinga noted that he is supposed to report to the IMF on what's happening with the shilling's exchange-rate, but that the dynamics are not entirely clear. He added that a stronger shilling is harming key export sectors, including horticulture and textiles, and does not

compliment Kenya's overall development objectives. Kalinga credits the Central Bank of Kenya for at least espousing an exchange-rate neutral position, notionally free from political interference. The shilling's enhanced value is likely due to a combination of factors, including increased capital inflows from donors and NGOs (again, the Southern Sudan factor), increased remittances, and weak demand for investment funds domestically.

Comment

¶14. (SBU) Kalinga appeared to be torn between an upbeat message on Kenya's progress and concerns about problematic foundations, including governance. As with Kalinga's previous exchange, the donors expressed on-going worries about governance, security, and the GOK's seriousness to pursue real reform. Ambassador Bellamy voiced our concern that President Kibaki and his pro-draft constitution's current policy of trying to buy votes by handing out title deeds, salary increases, and jobs is only a precursor for what will happen in the subsequent Presidential campaign. The likely consequence is that donors will be asked or required to take on more of the responsibility for meeting Kenya's basic needs during the next two years as the country's minimal development budget is further politicized.

¶15. (SBU) More immediately, we hope the IMF will be firm with Kenya in its discussions leading up to the December board meeting. On verifying asset declarations, it is important to have a public GOK commitment to whatever interim agreement is hammered out. Also, in outlining Kenya's budget framework and management, the IMF should push for policies that encourage sustainable economic growth and not allow the GOK to focus solely on meeting MDG criteria.

BELLAMY